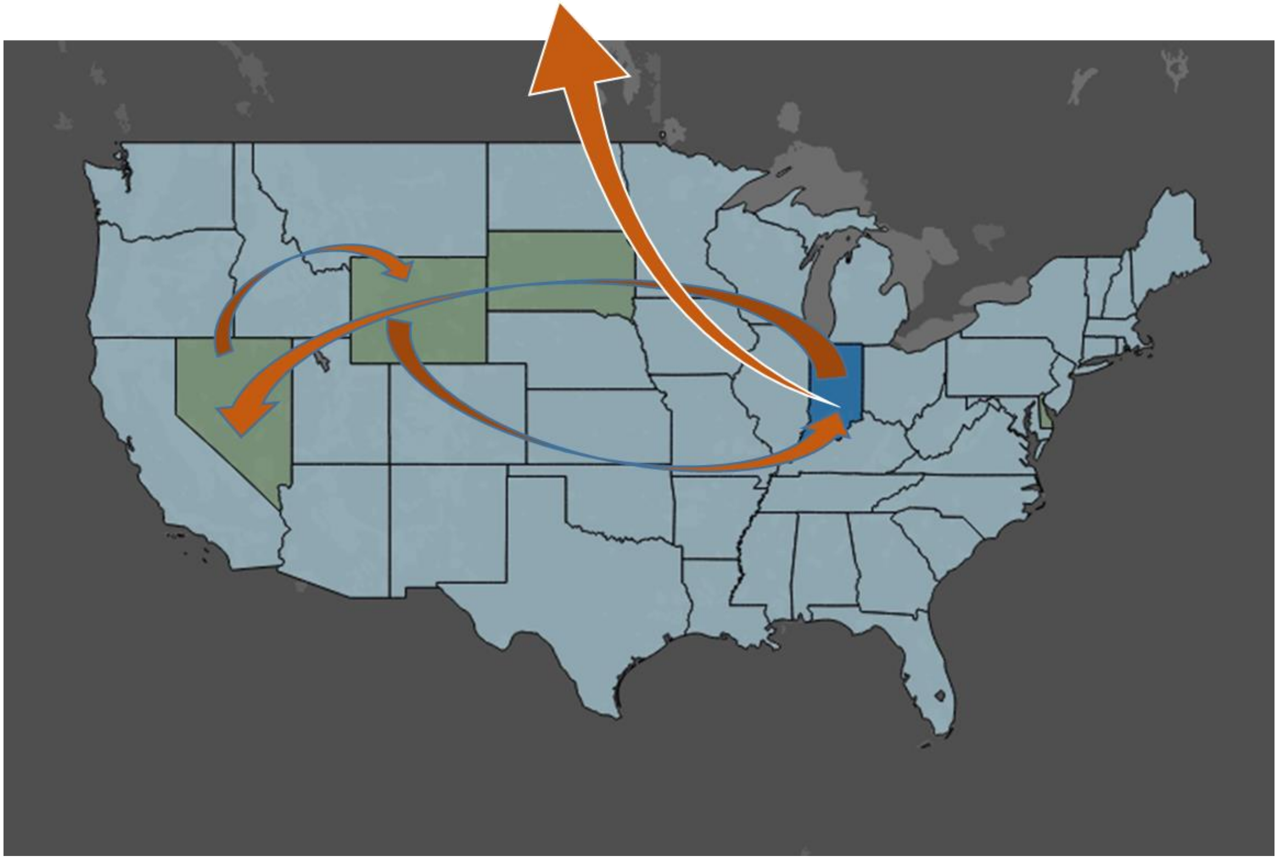

Transfer Pricing: A Review of Issues

OFFICE OF FISCAL AND MANAGEMENT ANALYSIS

INDIANA LEGISLATIVE SERVICES AGENCY

OCTOBER 1, 2016

Table of Contents

I: Introduction

SEA 323-2016 requires the Legislative Services Agency to study issues related to transfer pricing under the Adjusted Gross Income Tax.

A large portion of Indiana corporate taxpayers operate in more than one state. A substantial portion of their transactions actually takes place within the organization, as one division or affiliate supplies goods or services to another. These transactions could include the transfer of semi-finished or finished tangible property (or intangible property like trademarks or patents) or the provision of services. The decisions to conduct these transactions are based on factors such as production cost, transportation costs, holding costs, taxes and tariffs, and exchange rates for a multinational firm.

Transfer pricing is the accounting method by which a pecuniary value is attached to those internal transactions. It is primarily done for general accounting and tax purposes. Since transfer pricing involves intracompany transfers or intercompany transfers between affiliates, it does not directly impact a company's overall profitability. However, depending on market options, it could impact the profitability of the divisions or affiliates involved in the transaction.

These intercompany transactions could be between a company in a tax jurisdiction and its affiliate within or outside that jurisdiction. Internal Revenue Code Section 482 requires that for federal tax purposes, transfer prices should be set according to the arm's length principle, as if the related parties were operating on an unrelated basis. Historically, transfer pricing has been a significant issue for multinational companies. The focus is on making certain that the intercompany transactions meet federal and international accounting rules. Many domestic corporate taxpayers file consolidated federal tax returns. This means that for federal tax purposes, those domestic intercompany transactions have no federal tax implications. In other words, "for federal tax purposes, most transfer pricing issues are international in scope." (Griffith, 2012)

In the last two decades, transfer pricing has gained attention as a method of allocating profits and tax liabilities in order to minimize profits in high-tax states and to maximize profits in low-tax states. Charging substantially higher-than-market price from an affiliate that is in a high-tax state increases the expense of that affiliate, thus reducing their reported profitability.

II: Intercompany Transfer

Intercompany transactions between affiliates occur for various economic reasons. Generally, in a decentralized, multistate company, the management of an affiliate has autonomy to decide whether to conduct a transaction from inside or outside the organization. In the absence of purchase options, the transfer pricing decisions are not a factor. In the presence of market options, however, the seller would sell to an external entity if the market price is higher than the transfer price, and the buyer would buy from an external entity if the market price is lower than the transfer price. As a general rule the transfer price should be set equal to the sum of (1) the additional outlay cost per unit incurred because goods are transferred and (2) the opportunity cost per unit to the organization because of the transfer. In setting a transfer price, the taxpayers must ask, "what would an independent company operating in a competitive market charge for performing comparable services?"

Case 1 in the table below shows an example of an arm's length transfer price. This shows an effective use of an underlying opportunity in a multistate firm's supply chain. By using a transfer price set within the IRC Section 482 standards, the business entity could increase profit and compliance with the arm's length transaction.

CASE 1: Arm’s Length Transaction

X Corp. is controlled by ABC Corp. It manufactures transistors.
ABC has offered to buy 100,000 transistors from X Corp.
ABC currently buys transistors from external seller at $120 per unit.
X Corp. currently sells 300,000 transistors to external buyer.
X Corp. charges $125 per unit to the external buyer.

X Corp production cost for each unit of transistor is:

Labor	$30
Raw Input Material	$15
Overhead Cost	$15
Fixed Cost	$20
Total Cost	**$80**

X Corp’s production capacity is 500,000 unit of transistors. So it has 200,000 units of excess capacity.

Observation:

ABC is currently paying $120 per unit for a manufacturing input that its own affiliate with surplus capacity produces at a variable cost of $60 ($80 - $20). ABC should arrange for X Corp to supply/transfer the transistor to ABC. The company will save $6 M (100,000 * ($120 - $60)).

What is a potentially acceptable transfer price range if other information is available?

Based on the above information, an acceptable range to set the transfer price could be $60 to $125. (This range is just to show an example and several complex factors are considered in setting a transfer price.)

Case 2 illustrates an example of two different tax planning options. The initial option shows the transfer price for the intercompany transfer being potentially set pursuant to the arm’s length rule in IRC Section 482. The second option shows a transfer price that is well beyond the potential market price. The transfer price is set high, leading to income transfer from a high-tax state to a low-tax-state.

CASE 2: Tax Planning Options

X Corp. is in a low tax-rate state and ABC is in a high tax-rate state.

IN RANGE TRANSACTION **100,000 unit @ ($100 per unit)**	X Corp. Low Tax Rate	-	ABC Corp. High Tax Rate		Combined
Revenue	$10,000,000		$25,000,000		$35,000,000
Third Party Cost	($500,000)		($1,500,000)		($2,000,000)
Transfer Goods Cost			($10,000,000)		($10,000,000)
Taxable Income	$9,500,000		$13,500,000		$23,000,000
Tax Rate	5%		10%		
Tax Liability	**$475,000**		**$1,350,000**		**$1,825,000**
TAX PLANNING TRANSACTION **100,000 unit @ ($200 per unit)**	X Corp. Low Tax Rate		ABC Corp. High Tax Rate		Combined
Revenue	$20,000,000		$25,000,000		$45,000,000
Third Party Cost	($500,000)		($1,500,000)		($2,000,000)
Transfer Goods Cost			($20,000,000)		($20,000,000)
Taxable Income	$19,500,000		$3,500,000		$23,000,000
Tax Rate	5%		10%		
Tax Liability	**$975,000**		**$350,000**		**$1,325,000**

Whereas it is likely that an adjustment is warranted in the transaction where the transfer price is set to avoid taxes, it is unlikely to be warranted in a transaction which is within a transfer price range. The transfer price in the earlier case seems to be set within the arm's length range. If a tax department makes an adjustment in this transaction, then it may lead to litigation and cost to both the business and the state. An audit adjustment to the tax liability in the latter option may be very well justified due to probable tax planning techniques evidenced by the transfer price being set at substantially higher-than-market price. In the absence of an agreement between two state revenue departments, the audit adjustment would lead to double taxation on a portion of the taxpayer's income. Also, based on the adjustment, a state revenue department might determine that the seller has a nexus in the state. This could lead to the seller becoming a part of the company's overall apportionment formula and the tax base. This could create an ongoing liability for the out-of-state entity that otherwise would not pay taxes due to the absence of economic nexus in a state.

Some states recalculate the federal income and make an additional adjustment based on the flow-through of a federal transfer pricing adjustment. In order to avoid the long-term impact from adjustments and related litigation, taxpayers hire experts to set an acceptable transfer price.

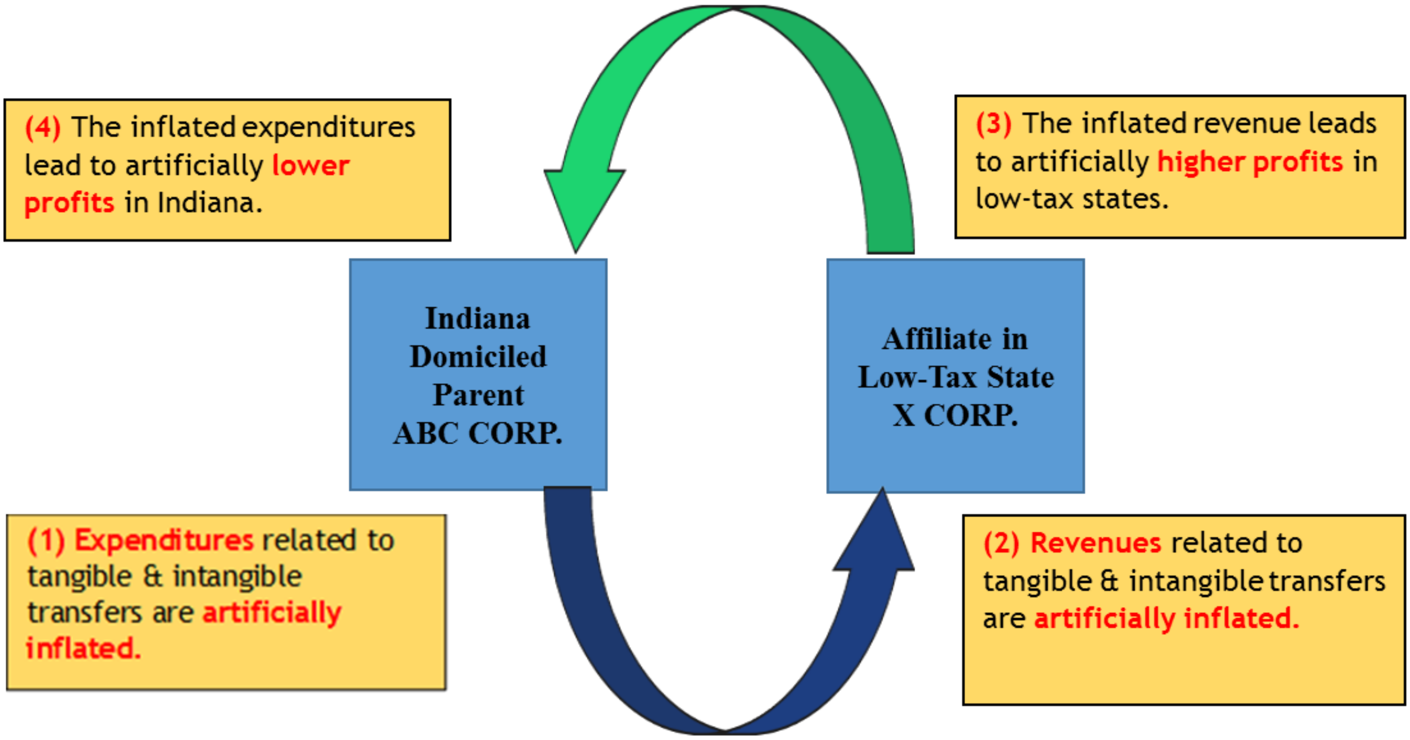

Chart 1: A graphic presentation of potential tax avoidance using transfer pricing.

III: State Enforcement of Intercompany Transfers

Audit divisions of state revenue departments have employed various methods to determine an appropriate transfer price. Most of these methods are outlined in IRC Section 482. For tangible goods, the IRS accepts the comparable uncontrolled price, resale price, cost-plus, comparable profit method (CPM), profit split, and other unspecified methods. For intangible goods, the IRS accepts the comparable uncontrolled transaction, CPM, profit split, and other unspecified methods. For services, the IRS accepts the services cost, comparable uncontrolled services price, gross services margin, cost of services plus, CPM, profit split, and other unspecified methods. The regulations provide a best-method rule for determining the appropriate method to be applied by the taxpayer for each intercompany transaction. (Ernst & Young)

The comparable price method, cost-plus method, and comparable profit method are the most commonly used methods. In reviewing the available case studies, it is evident that the comparable profit method is more often used by the states because of the difficulty in setting a comparable price or cost. The comparable profit method (CPM) is a transfer pricing method relying on the principle that taxpayers involved in similar business activities in similar circumstances tend to earn similar returns over time. The IRS guidelines also require certain steps to be taken, dependent on the selection of the method. For example, the comparable profit method selection would require selection of a profit-level indicator, comparable company selections, and quantitative analysis related to the arm's length test.

In many cases a government audit leads to tax liability adjustments. This could potentially result in substantial costs because the amount of profit is effectively taxed twice since the amount of profit in dispute is taxed in two different jurisdictions. This double taxation arising from transfer pricing audit adjustments is difficult to correct in most states. CPM's widespread acceptance by state revenue departments and its administrative ease of use gives taxpayers a reason to adopt this pricing method. Yet, even with the CPM being the dominant pricing method and the available guidelines in executing it in IRC Section 482, experienced practitioners hired by large enterprises have found the complexity of IRC Section 482 rules to be daunting. This is also true for the state officials who have sent auditors for IRC Section 482 training and augmented budgets to gain in-house expertise.

In trying to overcome the compliance challenge specifically related to a transfer pricing strategy, states have addressed the issue by (1) imputing an alternate expense/revenue, (2) adjusting or reattributing income, or (3) adjusting international pricing that the IRS did not adjust. States have taken various alternative approaches to correct the problem using a broader brush and long-term fixes. Some of the common measures are (1) adopting combined reporting, (2) asserting nexus or jurisdiction over a related party, (3) reversing or disregarding the transaction for lacking economic substance or business purpose, or (4) asserting alternative apportionment.

Some states, like Alabama and Maryland, have directly cross-referenced IRC Section 482 in their transfer pricing statutory provisions. Other states, like Kentucky and Connecticut, have statutes that are similar to IRC Section 482 but do not make a direct reference to IRC Section 482. Some states, like Virginia, have statutes that are broader than IRC Section 482. Indiana along with some other states provide some general discretionary powers to make adjustments to a taxpayer's tax return to fairly reflect the taxpayer's state taxable income.

In a recent case, Columbia Sportswear v. Indiana, December 15, 2015, the Indiana Tax Court noted that IC 6-3-2-2(m) is nearly identical to IRC Section 482. The Indiana Department of State Revenue adjusted a taxpayer's net income tax base. The Court ruled that IC 6-3-2-2(l) only allows adjustments to apportionment and allocation, not the tax base. The taxpayer reported functions performed out of state and presented a transfer pricing study as evidence that transactions were conducted at arm's length. The Indiana Tax Court stated that because IC 6-3-2-2(m) is similar to IRC Section 482, and thus a study based on those principles could be used to analyze the validity of the adjustments made by the state.

In short, transfer pricing-related issues open a myriad of questions, the complexity and scope of which are difficult problems for state administration. The complexity is similarly large for small businesses. Small businesses cannot afford to create intricate tax-saving structures. This provides an advantage to large businesses as it relates to state tax planning.

IV: Conclusion

Transactions between related parties are common practices in conducting business. In an economy with the types of business structure dominated by parent companies with affiliates in multiple states and countries, it is inconceivable for certain affiliates to not transfer goods, services, technology, and other intangibles to the other affiliates. Transfer pricing is a method to monetize these transactions for accounting and tax purposes.

Transfer pricing also presents a major tax planning opportunity and risk for multistate and multinational corporations. While creating a sustainable and defensible tax-efficient supply chain structure is an essential part of conducting business, state governments want to ensure that multistate companies are not artificially shifting taxable profits out of their jurisdictions. This is achieved by scrutinizing intercompany transfers.

Transfer pricing examination and analysis is complex and expensive. In addition, if a transfer pricing study is not conducted in an efficient and effective manner, it could be detrimental to the taxpayer. It could result in unwarranted penalties, interests, and double taxation. In order to overcome the complexity, state officials have received specific training, hired transfer pricing specialists, and used third-party consultants. These measures require substantial resources and budgets. To reduce the number of disputed transactions, most states have adopted statutes requiring addbacks and disallowing tax benefits that occur from related-party transactions.

Indiana's statutes require the addback of deductions taken for royalties, intangible related-party expenses, and intercompany interest. Other states, like Kentucky, South Carolina, and Wisconsin, have broader addback provisions. Several states have adopted or proposed mandatory combined reporting.

V: Illustrative Cases on Transfer Pricing Issues

- Matter of Astoria Financial Corp. & Affiliates, TAT(E)10-35(BT) (N.Y.C. Tax App. Trib. 2016)
  The New York City Tax Appeals Tribunal determined that an in-state parent company was not required to include it's out of state passive investment subsidiary in its New York City banking corporation tax return. The Tribunal then determined that Astoria Financial successfully rebutted the presumption of distortion by successfully showing that the intercorporate transactions at issue were conducted at arm's length.

- Rent-A-Center East v. Indiana Department of Revenue (2015)
  The Indiana Tax Court held that Rent-A-Center East, Inc. did not have to file a combined return with its out-of-state affiliates Rent-A-Center West and Rent-A-Center Texas. It rejected DOR's position that Rent-A-Center East engaged in tax avoidance measures and its intercompany transactions were not at arm's length rates. The taxpayer provided an independent transfer pricing study which was accepted by the Court.

- Microsoft Corp. v. Office of Tax and Revenue, District of Columbia (2012)
  A methodology relied upon by states to assess corporate taxpayers for transfer pricing violations was ruled invalid by a D.C. Administrative Law Judge (ALJ).

- In the Matter of Hallmark Marketing Corp. v. New York Division of Taxation (2007)
  The Court ruled that the New York Division of Taxation could not force an in-state subsidiary to file its franchise tax return on a combined basis with its out-of-state parent company because the subsidiary showed that its transactions with its parent company were at arm's length and its transfer pricing study reasonably applied IRC Section 482 principles.

- Carpenter Tech. Corp. v. Connecticut Department of Revenue Services (2000)
  The Court determined that the Commissioner did not have discretion to disallow interest deduction because the loans had economic substance and business purpose, and the arrangement did not inaccurately reflect income.

Bibliography

Avi-Yonah, Reuven S. "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation" Law & Economics Working Papers, *University of Michigan Law School*. (2007)

Cook, Eric. "Estimating U.S. Corporate Income Tax Lost to Tax Planning" *State Tax Notes*. (2016)

Chainbridge Software, LLC. "A Presentation to MTC, ALAS Advisory Group Meeting" (2014)

Clausing, Kimberly A. "The impact of Transfer Pricing on Intrafirm Trade, *National Bureau of Economic Research" NBER Working Paper No. 6688.* (1998)

Economic Analysis Group LLP. "A Presentation to MTC, ALAS Advisory Group Meeting" (2014)

Ernst & Young Global Limited. "2015-16 Worldwide Transfer Pricing Reference Guide" (2016)

Griffith, Cara. "States No-Hold-Barred Approach to Auditing Transfer Pricing Arrangements" State Tax Notes. (2012)

Multistate Tax Commission – "Arm's-Length Adjustment Service (ALAS) Conference" (2016)

Neuberger, Jonathan A. "A Presentation to Multistate Tax Commission – Arm's-Length Adjustment Service (ALAS)" *Economist Incorporated.* (2014)

Peters Advisors LLC. "A presentation to MTC – Arm's-Length Adjustment Service (ALAS)" (2014)

Silva, Ednaldo. "A Presentation to MTC Arm's Length Adjustment Conference" *RoyalStat.* (2014)

Sicilian, Shirley K., Karl Frieden, Bruce Fort, Keith Robinson. "BEPS and Transfer Pricing Implications for State and Local Tax". *KPMG*. (2016)

Taxadviser, The "CPM: The World Transfer Pricing Method" (2008)

Urquidi, Alfredo J. "An introduction to Transfer Pricing", *New School Economic Review.* (2008)

Vladimir Starkov. "Discussion of Questions Posed by MTC ALAS Group" *Economic Consulting Firms.* (2014)

APPENDIX A- Experts' Presentation to Multistate Tax Commission

The Multistate Tax Commission Arm's-Length Adjustment Service Committee (MTC – ALAS) asked experts various questions regarding transfer pricing. Below are a summary of their responses. (On August 18, 2016, ALAS was renamed the State Intercompany Transaction Advisory Service Committee.)

(1) What are the greatest challenges that states might face in improving tax compliance related to intercompany transactions that distort the reporting of income to their states?

(a) Training audit staff.
(b) Audit selecting process –Identification tools in returns are lacking.
(c) Selecting good consultants.
(d) Possible litigation.
(e) Lack of statutory authority.
(f) Many taxpayers do not track state-to-state transactions.
(g) Taxpayers are not required to prepare documentation.
(h) Intercompany data generally not available from state tax returns.

(2) What are some of the best ways for states to meet those challenges?

(a) Audit staff training.
(b) Hire experienced, objective consultants.

(3) Given the fact-intensive nature of transfer pricing work, how might states best integrate expertise in economics and statistical analysis with their audit and legal staffs in the tax administrative process?

(a) Staff-Integration (audit, appeals, litigation).

(4) What objections will states face from taxpayers as they increase their compliance work?

Concern about taxpayer confidentiality – we take this very seriously.
Cost – Initial basic study needed to set a specified method - $75 K to $500 K.
States are using transfer pricing as a tool to increase revenue.
Certain states may continue (or expand) with an unfair transfer pricing audit system that does not have a basis in Sec 482 regulations or OECD guidelines.

(5) What lessons can the states learn from other taxing authorities with regard to transfer pricing enforcement?

(a) IRC § 482 training.
(b) Combined filing issues including unitary reporting.
(c) Addback provisions.
(d) Taxpayers want certainty and offering advance pricing structures (or even informal audit "closing agreements") would be useful.

(6) What remedies are most effective in correcting income manipulation associated with intercompany transactions?

(a) Anti-PIC states will benefit from:
- Further training.
- Transfer pricing expertise.
- Additional information reporting on tax returns.
- Promulgation of regulations.
- Adoption of penalty provisions.
- Information sharing.

(b) Combined Return States:
- Some spend considerable time attempting to identify ways to shift income to entities outside the combined group (non-unitary entities or foreign entities).
- Previous efforts have involved the use of sophisticated special purpose entities and other means of creating non-includable corporations.
- With respect to these efforts, identification of the planning and statutory or regulatory fixes must follow the initial set up of these structures quickly.
- Information sharing is critical to a timely response.

(c) Forced combined
- We believe these states have the least effective tools to combat state tax planning.
- They offer no means by which the taxpayer can undo the benefits of state tax planning in the absence of an audit.
- This contrasts with combined return states that effectively eliminate income-shifting and anti-PIC states that disallow the income-shifting through the tax return itself.

(d) In our experience, most taxpayers are not artificially manipulating their income through transfer pricing at the state level.

(e) Identify those that are doing so, and pursue vigorously (and publicly).

(f) Create stronger transfer pricing reporting requirements in conjunction with state income tax returns.

(g) Consider requiring some form of attestation that transfer pricing is consistent with the arm's length standard.

(h) Consider requiring access to country-by-country reporting information that is now being recommended by the OECD.

(i) Consider creation of state-by-state reporting requirements.